BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of: Review of the Commission's Rules regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers.	WC Docket No. 03-173

MOTION
TO ACCEPT LATE-FILED COMMENTS
(COMMENTS ATTACHED)

The California Public Utilities Commission (California or CPUC) respectfully submits this motion to Accept Late-Filed Opening Comments in the above docket. The CPUC's Opening Comments were due on December 16, 2003. These Opening Comments are late because of the press of other business.

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Respectfully submitted,

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California Public Utilities
Commission

January 22, 2003

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LATE FILED OPENING COMMENTS OF THE PEOPLE OF THE STATE OF CALIFORNIA AND THE CALIFORNIA PUBLIC UTILITIES COMMISSION

The People of the State of California and the California Public Utilities Commission ("CPUC") hereby submits its Reply comments in response to the *Notice of Proposed Rulemaking (NPRM)* by which the Commission begins its first comprehensive review of the rules applicable to the pricing of unbundled network elements (UNEs).

I. BACKGROUND

Until the middle of the 1990's, local phone service was thought to be a natural monopoly. However, changes in governmental policies, as well as technological advances, have made competition among multiple providers of local service feasible. *AT&T v. Iowa Utils. Bd*. (Iowa Utils. Bd. I), 525 U.S. 366, 371

(1999). Specifically, Congress enacted the Telecommunications Act of 1996 (“1996 Act ‘), Pub. L. No. 104-104, 110 Stat. 56, to open local telecommunications markets to full competition. Congress recognized that no prospective entrant could entirely replicate an incumbent's existing local network infrastructure. Accordingly, in the local competition provisions of the 1996 Act, 47 U.S.C. 251-253, Congress provided the means for potential competitors to enter local markets by using the incumbents' networks in a variety of ways. In this regard, see 47 U.S.C. 251(c)(2)-(4).

Central to these local competition provisions is Section 251(c)(3), which entitles a new entrant to gain "access" to (i.e., to lease) an incumbent's "network elements," such as loops, switching capability, and other components and capabilities of the incumbent's network. 47 U.S.C. 251(c)(3); see also 47 U.S.C. 153(29) (defining "network element"). That provision permits new entrants, some of which may also have network elements of their own, to lease from an incumbent those elements that they need to provide services to their own customers. The 1996 Act further permits new entrants to "interconnect" their own facilities with those in the incumbent's network "at any technically feasible point." See 47 U.S.C. 251(c)(2).

However, the CPUC notes that throughout most of the United States, local telephone service in each community has long been dominated by a single incumbent "local exchange carrier," or LEC. That incumbent LEC, whether a Regional Bell Operating Company (“RBOC”) or an independent carrier, owns almost all of the loops (the wires that connect telephones to switches) in its service area, along with the switches (which direct calls to their destinations) and the transport trunks (which carry calls between switches). The incumbents' control over those facilities in the past has solidified their de facto monopoly position in most local telecommunications markets. Indeed, even today, after years of efforts to open those markets to competition, incumbents still provide service to approximately 87% of local telephone lines and control of 96% of the network. See, FCC Public Notice, entitled "Federal Communications Commission Releases Study on Telephone Trends," dated August 7, 2003.

An incumbent may charge a new entrant for interconnection and access to network elements. If the incumbent and the new entrant cannot agree on those charges, the 1996 Act authorizes the state public utility commission, acting as arbitrator, to set the rates that the incumbent may charge. The state commissions must set rates that are "nondiscriminatory" and "based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element." 47 U.S.C. 252(d)(1). These rates "may include a reasonable profit" for the incumbent. *Id*. In setting such rates, the state commissions must follow the FCC's pricing rules that give content to that statutory standard. See *Iowa Utils. Bd. I*, 525 U.S. at 383-385. Section 252(d)(1) provides as follows:

> Determinations by a State commission of the just and reasonable rate for the interconnection of facilities and equipment for purposes of subsection (c)(2) of section

> 251 of this title, and the just and reasonable rate for network elements for purposes of subsection (c)(3) of such section-- (A) shall be--(i) based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable), and (ii) nondiscriminatory, and (B) may include a reasonable profit.

The 1996 Act also conferred significant benefits on incumbent LECs. For example, the 1996 Act "relieves the [RBOCs] of several of the burdens imposed by the [1982 AT&T Consent Decree], particularly by prescribing in [47 U.S.C.] § 271 a method whereby [they] can achieve a long-sought-after presence in the long distance market." *BellSouth Corp. v. FCC*, 162 F.3d 678, 690 (D.C. Cir. 1998) (emphasis and citation omitted); see also 1996 Act, Title VI, § 601(a)(2), 110 Stat. 143 (superseding GTE consent decree). The 1996 Act further entitles incumbent LECs, like other telecommunications carriers, to invoke its local competition provisions to expand their operations into new geographic areas and compete for the customers of other incumbents.

In August 1996, the FCC issued its initial order addressing the most basic issues involving local competition arising under the 1996 Act. See *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order ("Local Competition Order"), 11 F.C.C.R. 15,499 (1996). A cornerstone of that order is the FCC's choice of the cost methodology – "total element long-run incremental cost," or TELRIC – that state public utility commissions are to employ in resolving disputes between carriers about the "cost[s]" that Section 252(d)(1) allows the incumbent to recover from the new entrant for providing interconnection and network elements. See Local Competition Order, paragraphs 674-703.

TELRIC embodies a "forward-looking" approach to calculating the cost of providing network elements and interconnection. The essential objective of any forward-looking methodology is to determine what it would cost in today's market to replace the functions of an asset that make it useful. That is the asset's "forward-looking" cost (also known as its "replacement" or "economic" cost), as distinguished from the cost of duplicating the asset in every physical particular. Thus, if a loop cost $100 to install in 1985 but would cost $150 to install today (because, for example, labor costs have increased), the rate for leasing that loop would be based on the higher current cost figure.

In asking what it would cost to replace the functions that make an asset valuable, a forward-looking cost methodology requires an inquiry into currently available substitutes, including assets that perform the same functions as the asset in the incumbent's network, but that do not resemble the asset in all respects (*e.g.*, because they embody more efficient technology than the original asset.

The forward-looking purchase price of an asset is only one variable in the TELRIC compensation calculus. TELRIC also takes into account: (1) the duration of an element's useful life, as reflected in an appropriate economic depreciation schedule; (2) the cost of capital (*i.e.*, the required return, or profit, on investment); and (3) various types of expenses, such as maintenance expenses. See Local

Competition Order at paragraph 703. One of TELRIC's principal objectives is to ensure an incumbent's opportunity, when leasing network elements to others, to recover the full forward-looking cost of those elements (including the cost of capital) over their useful lives.

Many of the essential details of implementing TELRIC are left to state public utility commissions. For example, the FCC did not set depreciation schedules itself; rather, state commissions determine, among other things, how best to adopt "specific depreciation rate adjustments that reflect expected asset values over time," including, where relevant, "expected declines in the value of capital goods." See, Local Competition Order at paragraph 686. Similarly, the state commissions have wide discretion to determine the appropriate cost of capital (or return on investment); they are authorized to increase the cost of capital, if warranted, to compensate incumbents for the risk of increased competition. See, Local Competition Order at paragraph 702.

The FCC rejected the argument of several incumbent LECs that the 1996 Act entitles them to rates for interconnection and network elements that are based on the "historical" (or "embedded") costs reflected on their accounting books. The FCC recognized that those costs could be either higher or lower than forward-looking costs. See, Local Competition Order at paragraph 705. The FCC reasoned that the use of historical costs would be economically arbitrary and would frustrate the competitive objectives of the 1996 Act. See, Local Competition Order at paragraphs 704-711.

In 1996 and 1997, the Eighth Circuit stayed and then invalidated the FCC's pricing rules on the ground that the 1996 Act gives state public utility commissions, not the FCC, general jurisdiction to interpret the pricing provisions of Sections 251 and 252. *Iowa Utils. Bd. v. FCC*, 120 F.3d 753, 794-800 (1997). The Eighth Circuit's jurisdictional orders remained in effect until early 1999. During that period, the great majority of state commissions, including California, voluntarily applied the FCC's basic forward-looking methodology in adjudicating disputes between incumbents and new entrants over the rates to be charged for interconnection and network elements. In January 1999, United States Supreme Court reversed the Eighth Circuit's jurisdictional ruling, holding that the FCC has statutory authority to establish national pricing standards under Sections 251 and 252 of the 1996 Act. *Iowa Utils. Bd. I*, 525 U.S. at 376-385.

The Supreme Court remanded the case to the Eighth Circuit to address (among other things) the substantive validity of the FCC's cost methodology. In July 2000, the Eighth Circuit issued its decision on remand. *Iowa Utilities Board v. FCC,* 219 F.3d 744 (8th Cir. 2000). In this decision, the Eighth Circuit upheld the FCC's authority to prescribe a pricing methodology based on forward-looking costs. Specifically, the court rejected the incumbents' argument that, in providing that the rates that they may charge new entrants for interconnection and network elements are to be based on "cost," Congress dictated a methodology based on historical cost. The Court concluded that "the term 'cost,' as it is used in the statute, is ambiguous, and Congress has not spoken directly on the meaning of the word in this context."

The Court therefore recognized that the FCC has the authority to make reasonable rules to resolve any such ambiguity (citing *Chevron U.S.A. Inc. v. NRDC, Inc*., 467 U.S. 837, 842-843 (1984)). The Court then concluded that the FCC's adoption of a methodology based on forward-looking costs was reasonable. The Court noted that "forward-looking costs have been recognized as promoting a competitive environment which is one of the stated purposes of the [1996] Act." *Ibid*. The Court found that the FCC had adequately explained its conclusion that a methodology based on forward-looking costs "would best ensure efficient investment decisions and competitive entry," and thus "implement the new competitive goals of the Act." *Ibid*.

The Eighth Circuit did, however, invalidate the FCC's rule specifying that, apart from the "wire center" exception, the forward-looking cost of an element should be "based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration." The Court held that this regulation was contrary to "the plain meaning" of Section 252(d)(1) and thus does not satisfy step one of a *Chevron* analysis.

The Eighth Circuit also rejected, as premature, the incumbents' assertion that the FCC's methodology, including its consideration of forward-looking costs, raises a serious Fifth Amendment takings issue that the 1996 Act should be construed to avoid.

On May 13, 2002, the U.S. Supreme Court issued an opinion in *Verizon Communications, Inc., et al., v. FCC*, 535 U.S. 467 (2002), which puts to rest any credible challenge in the future regarding the cost methodology that the California along with the FCC have used to set unbundled network element costs, *i.e.* the TELRIC methodology. Incumbent LECs had argued that TELRIC must include historic costs and investment. The Court soundly rejected this argument. The Court ruled that the FCC's interpretation of cost is reasonable, and said that "[w]ithout any better indication of meaning than the unadorned term, the word 'cost' in section 252 (d) (1) gives the ratesetting commissions broad methodological leeway but says little about method to be employed." Given the enormous latitude given by Congress around the term "cost," and given that Congress was clearly looking for the FCC to use a non-traditional method to establish costs for unbundled network elements, the use of TELRIC was found lawful. Moreover, in its decision, the Supreme Court rejected the arguments of the incumbent LECs regarding their "takings" claim, namely, that the TELRIC method violated the Fifth Amendment to the U.S. Constitution. There can accordingly no longer be any doubt that the TELRIC methodology has passes Constitutional muster.

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II. DISCUSSION

The FCC has sought comment on whether to adopt a TELRIC methodology more firmly rooted in the real world attributes of the existing network, rather than the speculative attributes of a hypothetical network. This has been a pivotal issue in the CPUC's current proceeding reexamining the unbundled loop and unbundled switching UNE costs for Pacific Bell Telephone Company (d/b/a SBC California)(A.01-02-024 and consolidated cases, hereinafter "UNE Reexamination"). In the CPUC's UNE Reexamination proceeding, the CPUC is considering two cost models, one filed by SBC and the other filed jointly by AT&T and WorldCom. SBC's model uses many attributes of the existing network including some, but certainly not all, of the current outside plant placements. The AT&T/WorldCom model uses a bottom-up approach to construct a network based on SBC's existing wire center locations and information on current customer locations. The AT&T/WorldCom model does not use the current routing of SBC's outside plant facilities to reach these customers.

Because the decision regarding which of these competing models to use is currently pending, the CPUC will not comment at this time on which of these approaches is preferable. Nevertheless, any refinements to TELRIC from the FCC on this topic will certainly streamline state proceedings by reducing time spent by parties and State Commission staff in litigating this issue every time TELRIC is used. It should also be noted that in the several years the CPUC has scrutinized TELRIC cost models, no cost model appears to be able to replicate all of the outside plant facilities of the incumbent carrier. Prior models, and the current models before the CPUC all use assumptions regarding placement of facilities. The CPUC in its current proceeding has heard evidence from modeling consultants that it would be extremely difficult to devise algorithms to mirror exact outside plant placement.

For the same reasons, the CPUC will not comment on the area of technology mix or long run vs. short run issues because these are also before the CPUC in our current proceeding. However, the CPUC will provide ex parte communications to the Commission at a later date when this proceeding is concluded.

Respectfully submitted,

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